



Wishful Thinking or Valuable Forecasts? The Value of Policy Rate Predictions in Sweden

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Article Information

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Abstract

Economists often provide predictions about future interest or policy rates. In contrast to stock market predictions, these forecasts are typically regarded seriously and presented with a degree of accuracy. This paper explores whether placing more confidence in policy rate predictions than stock market predictions is reasonable. It begins by examining historical policy rates predictions in Sweden, comparing them to actual rates to assess their accuracy. The paper then delves into the discussion of how costs of mispredictions, such as sudden and unexpected policy rate increases, can and should be addressed. Despite the Central Bank making predictions within confidence intervals and the banking sector regulating individuals' borrowing, the burden of unpredicted rate increases falls almost entirely on individuals. The paper addresses whether that is reasonable.

Introduction

Economists commonly make predictions about the future, and for many economists and institutions, making predictions is their main task. For instance, macroeconomists commonly predict, and are quoted on, the rate at which the economy will grow, whether interest rates are going up or down by how much, and what will happen to unemployment and inflation. Central Banks make policy rate predictions and present different scenarios with varying degrees of accuracy. Journalists and people give these predictions considerable attention and seem to place some trust in them.

That the predictions get attention and are referred to is not strange, as most people are affected by future interest rates or how the economy, in general, is developing. In order to make sensible investment and savings decisions, both individuals and firms need to have a sense of how future interest rates will develop.

Recently, due to the sudden and unexpected increase in interest rates, the consequences of higher interest rates for individuals, firms, and the overall economy have been addressed. Most economists predicted that interest rates would remain low for the foreseeable future. As mispredictions, both over- and underpredictions, from actual rates can have major impacts on households' and firms' finances and investment decisions, it becomes relevant to discuss who should carry the cost or risk with mispredictions. That is, who should be accountable when forecasts are off the mark? The Central Bank

in Sweden publishes predictions of future policy rates five times annually. The predicted rates are presented with three different levels of confidence: 50, 75 and 90%, suggesting that they are presented with some kind of accuracy.

Individuals and households in Sweden that want to borrow face several restrictions and regulations limiting who can borrow and how much. Private banks granting loans are regulated, and there are several restrictions regulating who and how much an individual/household can borrow. For instance, the maximum amount that can be borrowed with the home as security is 85% of the value of the home. Loans that exceed 50% of the home value need to be amortized by either one or 2% of the loan annually. On top of that, households with loans exceeding 450% of gross income need to pay off an additional 1% of the loan annually. Before granting private loans, banks make sure that households have enough to live on by calculating the required amount left to live on, taking into account a higher interest rate. Is it still reasonable to put all risk on individuals and households when they meet all the regulations and put faith in the predictions that the central bank makes?

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This paper starts by discussing whether there are reasons to believe that macroeconomic predictions are more reliable than stock price predictions. A large part of the paper analyzes how accurate policy rate predictions have been in Sweden. Forecasts of Swedish policy rates made by the Swedish Central Bank are compared to actual policy rates in an attempt to determine how well the forecasts correspond to actual rates and whether there is any pattern in mispredictions over time.

Finally, as the consequences of mispredictions can be severe, the paper discusses who is best suited to carry the risks and costs of mispredictions. Currently, private

individuals carry almost the entire risk. Is it reasonable that individuals themselves are responsible, or should the Central Bank, private banks, or the government (taxpayers) carry some of the responsibility?

The more general issues discussed in the paper address the important aspects of risk-taking and risk-sharing. As the level of uncertainty is increasing in the economy, due to the geopolitical situations, new technology, climate change, possible future pandemics, or other crises it is of great importance to discuss and determine who is best suitable to bear risks. The paper focuses on interest rate uncertainty but could be generalized to cover other types of risks as well. In order to address the questions raised in the paper, the Efficient Market Hypothesis (EMH) and the theory of the superior insurer are employed. Additionally, the empirical part tests the accuracy of the predictions using data from the Swedish Central Bank covering an extensive period of time.

Are policy rate predictions more trustworthy and informative than stock price predictions?

The sudden increase in interest rates took many by surprise and was not in line with predictions. One commonly expressed argument for why the policy rates would remain low for the foreseeable future was that the rates had been low for a long time and, hence, would continue to be low. This is an interesting argument, as economists commonly criticize investment bankers for predicting stock prices based on historical stock prices, a practice typically referred to as technical analysis—a methodology most academic researchers don't believe to be useful as a predictor for future prices. Empirical research tends to support the notion that technical analysis performs poorly [1]. Why, then, would we trust macro predictions based on historical data when we don't trust financial predictions based on historical data?

To be fair, economists do not only look at historical data but also incorporate other information into their prediction models. For example, demographic development, technological changes, savings behavior, and changes in world demand and supply are considered as well. But, once again, economists in general do not believe that this type of analysis, referred to as fundamental analysis, works well when it comes to predicting stock prices. The reason for economists' lack of faith in fundamental analysis is that the market is assumed to be efficient, and all available information is already accounted for in existing prices. Hence, predicting stock prices based on available information is considered useless, as changes in stock prices only reflect unexpected new information.

The idea that stock prices are hard to predict extends far back in time. Perhaps the most well-known advocate for this is Eugene Fama [2] and his hypothesis about market

efficiency. The Efficient Market Hypothesis (EMH) is a well-known theory within financial economics and was rewarded with a Nobel Prize in Economics in 1993, along with a major opponent of the EMH, Robert Schiller.

EMH claims that stock prices are hard to predict using available information, as this information has already been incorporated into stock prices. There are three levels of market efficiencies associated with different levels of information incorporated in the price. If the market meets the lowest level of efficiency, weak efficiency, stock prices cannot be predicted using historical data or technical analysis. The reason for this is that this information has already been used and incorporated into stock prices. This implies that an investor cannot consistently make abnormal profits, profits above the risk compensation, based on investment decisions using information about how well stocks performed historically, as this information is already priced in. The next level of efficiency is semi-strong efficiency; the market is said to be semi-strong efficient if all publicly available information is also incorporated into stock prices. If this is the case, fundamental analysis, where all available public information is used to predict future stock prices, is fruitless. Finally, if the market exhibits strong efficiency, private information (inside information) cannot be used to predict future stock prices.

Empirical tests of the Efficient Market Hypothesis (EMH) have been conducted using various methods and data sources, aiming to examine whether financial markets exhibit the levels of efficiency proposed by the EMH. It's important to note that the results of these tests are not universally consistent, and ongoing debate persists in the academic literature. There is considerable consensus that the market does not meet a strong level of efficiency; inside information can be used to make abnormal profits. In general, and perhaps not surprisingly, academics are more inclined to believe in the EMH than practitioners. According to the former, the market seems to be somewhere between weak and semi-strong efficiency [3], but the last word on this matter is far from said.

Regardless of the relevance of the EMH, there seems to be a mismatch in the faith economists place in financial actors predicting stock prices and macroeconomists predicting future policy rates. Is there any reason to put more faith in policy rate predictions than in stock price predictions? There are several similarities between the two types of predictions, but also important differences that may explain why they differ.

One similarity is that future rates, both stock prices and policy rates, seem to be affected by sudden and unpredictable events. Inflation rates, and hence policy

rates, changed drastically during the financial crisis, the COVID-19 pandemic, and the invasion of Ukraine—events that were hard to predict but had major impacts on both the stock market and policy rates. According to the EMH, stock prices are impacted by sudden and unpredictable events that, hence, could not already be accounted for in current prices. Jumping ahead, results presented later in the paper show that forecasts were particularly off predicting rates in turbulent times.

Another similarity is that both stock prices and future interest rates are determined by psychological factors and beliefs about future prices. If future beliefs can be influenced, then future prices will also be affected. For instance, predicting future policy rates can be self-fulfilling. Interest rates are naturally linked to inflation, as the target is to keep inflation within a range of around 2% and the policy rate is the main instrument used to fulfill this aim. Central banks try to influence future inflation by convincingly demonstrating that they can lower the inflation rate and will do what is in their power to ensure inflation falls within its target range. If central banks are convincing in reaching their target, individuals will not ask for compensation for inflation, e.g., higher wages. But if inflation is believed to be a long-run problem, individuals will demand compensation (higher wages) and then fuel an inflation spiral. To prevent this from happening, central banks try to convincingly show that they will do whatever is in their power to meet the goal. If central banks have credibility in reaching the target, they may have more power to impact future interest rates. This is similar to financial assets, as these are valued by discounted future cash flows. This affects future beliefs about cash flows and, hence, impacts current stock prices.

Stock market predictions differ from policy rate predictions in that they are made by millions of different actors (basically everybody who participates in the market), and it is their very aim to find mispriced assets, and thereby make the market efficient. Hence, it is only unexpected new information that will lead to unexpected developments in prices, and hence, the ability to make excess profit. The EMH assumes that mispriced stocks are detected and taken advantage of quickly for them to vanish. This is not the case for inflation. Inflation is often caused by external events (changes in demand or supply), and even if future inflation can be affected by inflation expectations that central banks influence, the link between the central banks' actions and future inflation is weaker than the link between financial actors and stock prices.

To sum up, even with several similarities between different types of predictions, inflation or interest rates are probably, in theory, easier to predict than future stock prices, making central banks better equipped to predict